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GCC financial markets and the quest for development

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Abstract:
Jaber attempts to analyze the structure and economic role of financial markets in the GCC countries. Starting with an overview of the size, scope and systemic features of the banking sector and capital markets, this study then assesses the role that these markets currently play in the economic development of the GCC nations.

Full Text:

[Headnote]
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Over the past three decades, the countries of the Gulf Cooperation Council (GCC) have witnessed considerable improvements in their overall standards of living. Fueled by a dramatic increase in the price of oil during the 1970s, per capita GDP in the region has grown from a simple average of $2,366 in 1970 to $12,496 in 1996. Nevertheless, this general improvement in aggregate wealth has not been accompanied by policies that would insure a high sustainable level of consumption for citizens once resources have been depleted. The economies of the GCC nations continue to be largely dominated by the oil sector and thus remain at the mercy of fluctuations in the price of petroleum on international markets. Additionally, conflicting government policies and a general lack of resolve for economic diversification have stemmed the emergence of a vibrant private sector in these countries. As an essential part of the economic structure, financial markets in the GCC countries have also witnessed a number of changes over this period. The idiosyncratic characteristics of these markets and their effective contribution to economic development have been shaped as much by the massive inflow of resources to the region as by the economic and regulatory policies implemented by the GCC governments.

This paper attempts to analyze the structure and economic role of financial markets in the GCC countries. Starting with an overview of the size, scope and systemic features of the banking sector and capital markets, this study then assesses the role that these markets currently play in the economic development of the GCC nations.

OVERVIEW

The relative size of the financial sector, as reflected by its share in GDP, varies considerably among the GCC countries (Figure 1). Whereas the financial sector accounts for less than I percent of Oman's GDP, it claims 3.8 percent of Saudi Arabia's GDP and 10.5 percent of Qatar's. Moreover, the size of the financial sector in these countries is relatively small when compared to those of other upper-middle-income countries such as Chile (13.5 percent) and Korea (17.2 percent) or developed countries such as the United States (18.2 percent).

The Banking Sector

In the GCC countries, the banking industry is relatively young, with the oldest banks dating back to no earlier than the 1950s. Although the majority are privately owned, the role of the public sector remains substantial. Whether through equity participation in several banks or through a number of government-owned specialized credit institutions that provide financing to public- and private-sector enterprises at subsidized rates, the public sector continues to have a prominent role in the banking industry of the GCC countries. Privatesector ownership of financial institutions also tends to be concentrated in a few shareholders; a matter that reduces the threats (and benefits) of the market for corporate control. In addition, all GCC countries have moratoria on the establishment of new banks and foreign banks.

The latter are permitted only minority ownership of local banks.1

Scale and scope

The size of the banking sector in GCC countries, in absolute terms, is relatively small when compared to those of other developed countries (Figure 2). The aggregate assets of Saudi Arabian commercial banks (the largest in the region) are valued at about 2 percent of those of the United States.2 However, when the economic size of the GCC countries is taken into consideration, the scale of their banking sectors turns out to be significant (Figure 3). In fact, as a percentage of GDP, the aggregate assets of Kuwaiti commercial banks (221.8 percent) are 3.6 times greater than those of U.S. banks (61.8 percent). Similarly, the aggregate commercial-bank assets of UAE (127.1 percent) and Saudi Arabian (69.7 percent) banks are 2.1 and 1. 1 times higher, respectively, than those of U.S. banks.

GCC financial markets are sometimes characterized as being "over-banked." It has been further argued that the existence of such a banking structure is overcrowding the market and reducing lending margins. At first glance, however, the data do not seem to support this claim for all the GCC countries (Figure 4). Whereas GDP divided by the number of commercial banks in Bahrain ($0.28 billion) and Qatar ($0.6 billion) is certainly lower than that of the United States ($0.89 billion), thus revealing a certain degree of over-banking, the same does not hold true for the other GCC countries. In fact, the number of banks in relation to GDP in Kuwait, Oman, Saudi Arabia and the UAE is lower than it is in the United States. Such reasoning, however, does not take into consideration the increasing importance of economies of scale in the banking industry. Due to the limited size of the market that they service, GCC commercial banks are faced with a strong need for consolidation. In order to evolve into major players in international financial markets, it is imperative that these banks succeed in expanding their asset base. Such a strategy will allow them to improve the quality of their assets, through proper diversification, and to invest in expensive new technology that has increasingly become, and will continue to be in the foreseeable future, critical to success in the global banking industry. In fact, the reluctance (or inability) of GCC banks to embrace technological innovations and their continued focus on traditional banking products in the midst of increasing consumer sophistication have led a great number of their potential customers to seek investments abroad. In expressing his view on this issue, Mr. Salem Al-Sabah, the governor of the central bank of Kuwait, stated:

It can be said that this lagging behind in technological progress and modem customer services, in addition to the limited nature of the Gulf markets and their inability to absorb promising investment opportunities, has greatly contributed to the widening gap between internal and external Arab investments.... Gulf banks have to invest in advanced technology to be able to offer non-traditional services; otherwise they will lose a large number of their customers.3

Another feature of the banking industry in GCC countries is the high degree of market concentration. In their analysis of this issue, Jbili et al. found that:

In Saudi Arabia (1996) and Oman (1994) the three largest banks accounted for approximately one-half of total bank assets, equity and loans, with one bank accounting for approximately one-fifth of assets and equity. These ratios are even higher in Kuwait, where the three largest banks accounted for nearly 80 percent of the banking sector's total assets and equity in 1995, while the largest single bank accounted for one-third.4

The benefits (and costs) of such a market structure largely depend on the dynamics of the banking industry in the GCC countries. On a positive note, high industry concentration could lead to larger banks with a more diversified asset base and a greater capacity to keep up with the changing nature of the banking industry worldwide. Moreover, it has often been argued that it is not the degree of market concentration that is necessarily problematic - especially in an industry where entry costs are high - rather, it is the existence of barriers to new competition. The presence of "dynamic" competition and the constant threat of new market entrants keep industry players competitive and efficient. Only in such an environment will high market concentration not result in a monopolistic environment. As mentioned earlier, however, all GCC countries have moratoria on the establishment of new banks, shielding existing banks from the threat of new competition. The negative effects of this strategy are especially pertinent to the case of foreign banks. For by closing the door to these banks, GCC governments have not only reduced the level of competition, but they have also halted the "dynamic gains" that accompany foreign investments. These gains are generated through the transfer of technological innovations, managerial know-how and foreign expertise in product diversification and customer service - all necessary if GCC banks are to someday become major players in world markets. Moreover, the lowering of barriers to foreign entry is of special importance to GCC countries that have entered the World Trade Organization (WTO) and now need to reconcile their national laws with the requirements of the General Agreement on Trade in Services (GATS). For the countries that have not yet acquired WTO membership (i.e. Oman and Saudi Arabia), the issue of financial market liberalization is no less important, as it will certainly play a critical role in insuring their future entry.5

A related issue is that of inter-regional banking. Cross-border lending within the GCC has been approved by the organization's council for a number of years now. Moreover, during the eighteenth GCC summit in December 1997, government leaders agreed to allow banks headquartered in one GCC nation to open branches in other member countries previously a privilege reserved to the Gulf International Bank, which is owned by the six member governments.6 Despite these efforts to bolster interregional banking, it has not yet shown any significant signs of growth, due to several factors. First, by shielding domestic banks from competition, the GCC governments have indirectly granted them quasi-monopolistic powers in their local markets; this, in turn, has reduced their incentive to expand into other countries. Second, it can be safely argued that one of the main incentives for the expansion of inter-regional banking is the growth of inter-GCC trade in goods and services. Yet the level of inter-GCC trade continues to claim only a minimal share of the member countries' overall external trade. Third, the absence of a common regulatory framework in the GCC countries, as discussed below, creates substantial impediments to the free flow of financial services across boundaries. Finally, if one were to assume that the maximization of returns and the maintenance of diversified loan portfolios are at the heart of sound bank management, then inter-GCC expansion is difficult to validate. For one, the returns on investments outside the GCC area are often greater than on interregional alternatives and are unfettered by the bureaucratic and regulatory hassles that tend to accompany investments in the region. Furthermore, due to the vastly similar economic policies followed by the GCC governments, the dominant share of the oil sector in their economies and the pervasive role of the public sector, the economic cycles of GCC countries have been and in the absence of necessary reforms, will continue to be strongly correlated over time. Consequently, for a GCC bank seeking portfolio diversification, the appeal of inter-regional investments is diminished not necessarily by the intrinsic risks of the investments themselves, but by the minimal degree of diversification that they would offer the institution's already regionallybiased portfolio.

Due to the lack of diversification away from petroleum in the GCC countries, it is not surprising to note that the performance of banks in the region has been substantially affected by changes in oil prices over time. During years of high oil prices, GCC banks have done well. As indicated in Figures 5 and 6, during 1996 and 1997 (years of relatively high oil prices), top banks in the region have managed to yield a handsome return on their assets and equity, Omani banks being the leaders with a 2.37 percent return on assets and a 26.61 percent return on equity. However, the general economic slowdown in the Gulf region during 1998, largely instigated by the collapse of oil prices, has led to a decline in the profitability of its banks.7 By serving a region that is excessively dependent on petroleum for economic growth, GCC banks have in fact fallen prey to the uncertainties of the oil market. The effect of oil-price changes on the profitability of banks has been further accentuated by the allotment of a relatively large share of bank assets to a public sector that is heavily dependent on petroleum for its revenues. Here again, one needs to stress the importance of diversification for GCC banks. Without proper asset diversification across industries and regions, the volatility of earnings will be unavoidable, a matter that could seriously endanger the prospects of expensive and necessary investments in technology and managerial restructuring within these banks. In addressing the issue of profitability, GCC banks have to pay special attention to their cost structures.

Of particular concern are the costs associated with wages and salaries. At the moment, their labor costs are relatively high when compared to a global banking industry in which downsizing and higher employee productivity have become crucial to success. Yet in the words of Mr. AlSabah, "Certain Gulf banks lack a clear strategy to substantially reduce the ratios of wages to total revenues."8

An important measure of the banking sector's economic role in the GCC countries is the relative size of the domestic credit extended by banks (Figure 7). As a percentage of GDP, domestic credit provided by Kuwaiti banks (103.2 percent) is the highest among all GCC member states, It is also relatively higher than that of other upper-middle-income countries such as Chile and Korea, which points to an active role for Kuwaiti banks in their economies. On a less positive note, the figure for the most populous GCC state and the one with the largest economy, Saudi Arabia, is not particularly impressive. At about 38 percent of GDP, domestic credit provided by the banking sector in Saudi Arabia - with the exclusion of credit to the central government - stands at less than a third of that of a developed economy such as the United States. This is probably due to the large share of bank assets that have been allotted to the central government of Saudi Arabia in the form of development bonds and to the dominant role of specialized credit institutions in longterm lending, which in effect has constricted private financial institutions to the short-term end of the market. The figure for Bahrain (14.7 percent) should be viewed with caution. For although the level of domestic credit provided by the banking sector is very small by either regional or global standards, it does not accurately depict the overall economic contribution of the industry to Bahrain's economy. The differentiating factor here is that in addition to the 19 banks serving its domestic market, Bahrain is home to more than 46 Offshore Banking Units (OBUs), whose domestic activities are limited. These OBUs, however, are among the biggest and most profitable financial institutions in the Arab world, and their indirect impact on the domestic economy is undeniable.

On the aggregate, bank credit to the public sector is generally high in most GCC countries (Figure 8). At 27.3 percent of total assets, bank claims on the public sector in Saudi Arabia are 3.7 times greater than those of U.S. banks. Similarly, claims of Kuwaiti banks on the public sector (at 23.3 percent of total assets) are 3.2 times greater than those of U.S. banks. In the case of the UAE, however, publicsector lending seems to capture a much smaller share of total bank assets (6.93 percent), reflecting the more diversified nature of its economy - especially in Dubai - and the government's efforts to decrease the economy's reliance on petroleum.

In view of the pervasive government role in the GCC economies and of the lack of significant private-sector development, such results are not entirely surprising. The dearth of lucrative investment and lending opportunities in the private sector and the provision of public-sector financing at subsidized rates has driven banks towards secure government assets. This has also pushed banks to the short-term end of the market and away from the financing of long-term industrial projects. Jbili et al. estimate that while trade, construction and real-estate activities account for about 30 to 45 percent of lending by GCC banks, the industrial sector's share has generally been less than 10 percent.9

Another result of government financing and of sluggish private-sector development has been the channeling of funds into foreign investments. Figure 9 reveals that, as a percentage of total assets, net foreign assets of commercial banks in the three largest GCC countries are substantial. In terms of portfolio diversification, foreign investments are certainly beneficial to banks in the region, However, such channeling of funds abroad necessarily diminishes the banks' valuable role as financial intermediaries. As will be discussed below, these factors have marginal ized the role of financial institutions in the economic development of the GCC countries. Moreover, the relatively high level of foreign assets held by GCC banks can be partly blamed on the interestrate ceilings that have been imposed by monetary authorities. Although in recent years interest-rate caps - such as maximum lending rates in Kuwait and Oman and ceilings on deposit rates in Qatar have by and large been non-binding, their very existence weakens the role of interest rates as an unbiased estimate of the "true" opportunity cost of capital. Moreover, interest-rate ceilings, coupled with fixed exchange-rate systems (adopted by all the GCC states) and free movement of capital, have heightened the incentive of GCC banks to channel their investments abroad in search of higher profits.

The soundness of a country's financial system and the regulatory framework within which it operates are partly shaped by the adverse shocks that the system endures over time and by the regulator's response to such shocks. In this regard, GCC banks have been able to regain a sound standing in the aftermath of the financial crises to which they have been subjected: the property-market crisis during the 1980s, the collapse of the parallel Kuwaiti stock market in 1982 and the 1990 Gulf War. In terms of capitalization, all GCC regulators now require that banks abide by the Basle Committee's minimum capital standards. Figure 10 reveals that the top GCC banks are well capitalized, with Qatari banks having the highest capital-to-asset ratios, at 12.9 percent. Even the least capitalized banks in the region - the Omani banks - have maintained a capital-to-asset ratio close to 9 percent.10 Yet the implementation of the Basle requirements has also had a negative indirect effect on GCC banks. The Committee gave the GCC countries a nonOECD status (except for Saudi Arabia) with the result that minimum-risk-weighting requirements have reduced the access of the region's banks to funding from abroad. In the words of the CEO of the Gulf Investment Corporation, Khaled Al-Fayez:

This has resulted in a negative effect on the funding lines available to Gulf banks from abroad due to perceived risk in their portfolios and has made Gulf banks more reliant on local funding. It has also constrained their activities in their traditional markets due to the risk weighting of these markets.11

Regulatory framework

The degree of government intervention in a free-market economy has always been a matter of concern to economists. Despite much debate about the adequacy (or appropriateness) of intervention in certain instances, a widely accepted axiom is that in the presence of market failures whether due to economic externalities or to distortions in the price mechanism that restricts the efficient allocation of resources - government intervention is merited. In justifying government regulation of financial markets, Stiglitz et al. (1993) point to the presence of a number of market failures that necessitate intervention: (i) the public-good aspect of monitoring, (ii) the problem of adverse selection and lending externalities, (iii) the consequences of financial disruption and subsequent economy-wide externalities, (iv) the issue of inherent imperfect competition and (v) the problem of uninformed investors. 12

These factors are especially relevant to developing countries due to the infant nature of their financial sectors, the widespread existence of market imperfections, the relatively unsophisticated nature of their investors and their vulnerability to massive capital flows in international markets. As such, it would be difficult to over-emphasize the importance of a solid regulatory framework for financial markets in developing economies.

The main pillar of the regulatory environment in the banking sector is the rule of law, which delimits the rights and responsibilities of market participants. Shihata(1996) identifies a number of elements that need to be at the core of a "good" banking law: (i) the goal of insuring financial stability and the maintenance of public confidence in the financial system, (ii) the administration of a fair and competitive banking environment, (iii) the provision of adequate protection to depositors (especially small ones), (iv) the establishment of special courts to expedite rulings on disputes between banks and depositors, (v) the delineation of the banks' area of activities, (vi) the guarding against systemic bank failures, (vii) the provision for a medium by which the law can be updated as necessary in order to take into consideration changes and innovations in financial markets. Yet having a "good" banking law is not enough to ensure the soundness of financial institutions. There also needs to be a strict and non-politicized enforcement mechanism in place. More important, regulators should encourage the development of market-based control mechanisms that require the existence of, among other things, adequate disclosure and transparency of financial institutions, up-to-date financial statements and market-position reports, appropriate accounting and auditing systems within banks, and credit-rating agencies whose findings are made available to the public. The importance of such control mechanisms is accentuated by the dynamic nature of financial markets in the face of the inevitable hurdles facing most regulatory changes and by the need to protect the financial sector from the dangers of over-regulation.13

All GCC countries have laws that lay down a comprehensive framework for the banking industry's regulatory and supervisory structures. These laws also go a long way in delimiting (sometimes excessively) the activities of financial institutions operating within their boundaries. Nevertheless, banking laws in the GCC countries do suffer from a number of shortcomings. For one, these laws are relatively dated, with the newest banking law in the region - that of the UAE - originating in 1980. They do not necessarily incorporate the regulatory developments that have occurred during the late 1980s and 1990s. Nor do they take into consideration the global changes that have taken place in the banking industry over this period.14

Second, despite the elaborate structure of GCC banking laws, they remain prudential in nature. "They are mainly confined to prudential standards related to credit risk and are designed to guarantee the liquidity of banks and the soundness of their operations, with a view to preventing bank failure."15 In other words, very few of these laws rely on market-based mechanisms to complement the existing rule of law. Of critical importance here is the issue of banking transparency (the lack of which has proven to be one of the main factors leading to the 1997 Asian crisis). The provision of accurate and up-to-date information to the market reduces the possibility of speculation and allows for external monitoring that is free of possible favoritism by regulatory authorities. Although progress has been made in this regard by GCC regulators, there exists substantial room for improvement. Whereas banks in Saudi Arabia and Kuwait are required by the authorities to regularly publish audited financial statements, such a level of disclosure is not the rule in the GCC countries.16

Third, none of the GCC banking laws are in conformity with the minimum standards for consolidated supervision of international banking groups stipulated by the Basle Committee in 1992. The role of supervisory authorities has yet to be extended to cases where the bank forms only one part of a holding company's many ventures.17

Fourth, banking laws in the GCC countries are restrictive in terms of delimiting the activities of financial institutions. They do not seem to conform to the global trend of "universal" banking that has allowed Western banks to offer their customers a more complete range of products, while concurrently increasing the competitiveness of these banks and allowing them to diversify their portfolios more efficiently.18

Fifth, banking laws in the GCC provide very little guidance for the process of mergers and acquisitions of financial institutions. Besides their requirement for prior approval of any merger by the supervisory authorities, these laws do not offer clear guidelines for institutions that are seeking to unify their operations. 19 The absence of such guidelines is all the more important given the need for consolidation among financial institutions in the GCC, as discussed earlier.

Sixth, although monetary authorities have been making serious efforts to modernize the infrastructure of payments systems in the GCC countries, the rules governing the transfer of funds between financial institutions have not been adapted to the changing environment. Little progress has been made in these countries to implement a legal framework for the adoption of payments systems that are not dependent on the exchange of signed documents but rather on more modem and rapid ways of communication.20

Seventh, some of the GCC countries still lack a deposit-insurance system to protect depositors (mainly smaller ones) in the case of bank failure. Although such a system might raise the issue of moral hazard, it is necessary for establishing depositor confidence and for reducing the systemic risks associated with the banking sector. Here again, one needs to stress that such a scheme, although valuable, is not a substitute for the proper and timely disclosure of information by financial institutions.

Eighth, in none of the GCC countries is the issue of extra-territorial supervision given the attention that it warrants. Banking laws in these countries do not require banks to submit statements, or reports, on the activities of their foreign branches and subsidiaries.21 This issue is particularly relevant to the GCC's efforts towards financial-market integration mentioned earlier. It would be helpful here to refer to the European Union's (EU) home-country-supervision and single-license model. Implemented in 1993, the model allows an EU bank to operate and open branches in other member countries while being under the supervision of only one regulator: the one presiding over the country in which it is headquartered. In addition to minimizing transaction and monitoring costs, this has considerably increased the competitive structure of the EU banking industry and has allowed banks to reap the benefits of economies of scale. Yet such a supervisory model would not have been possible had it not been preceded by a harmonization of banking regulations among EU members (as evidenced by the numerous EU directives on this issue). For GCC countries, this means that achieving a successful integration of financial markets will have to be preceded by: (i) an extension of the regulators' supervisory duties beyond the geographic boundaries of their markets, and (ii) a harmonization of the regulatory laws that govern financial markets in individual GCC countries. Without such changes, transaction and regulatory costs would impede the expansion of GCC banks within the region. Furthermore, any such expansion could prove to be a nightmare for regulators in the absence of clear supervisory laws that regulate the activities of banks beyond national boundaries.

Ninth, a major policy issue facing banking regulators in the GCC countries is the supervision of the rapidly growing Islamic banks. In general, depositors in such institutions are guaranteed neither the principal nor interest on their money. In turn, this shifts a substantial part of the credit risks normally borne by traditional banks onto depositors. The agency costs that are generated by such a mechanism are self-evident and far-reaching. In the absence of a binding requirement to safeguard their customers' deposits, Islamic banks have little incentive to hold sufficient collateral on their loans. Furthermore, the affinity of these banks for highrisk investments might be increased due to their lower exposure to the consequences of project failure. Yet for the financial sector as a whole, the collapse of an Islamic bank carries with it the same systemic impact as would the failure of any traditional bank. In view of the serious repercussions that could result from the mismanagement of Islamic banks and of the special nature of these institutions, they require special attention from banking regulators in the form of. (i) closer monitoring of the activities of these banks, (ii) greater transparency of their lending operations and aggregate financial position, and (iii) clearer accounting and auditing standards to complement their inherently complex modes of financing.22

Finally, it is important to note that a banking law, regardless of its level of sophistication and completeness, forms only a small part of a nation's comprehensive legal system. Therefore, the effectiveness of banking supervision is unequivocally linked to the rest of a country's jurisprudence and enforcement mechanisms. In this regard, the GCC countries have to pay special attention to a number of issues, such as the establishment of a sound and fair rule of law. Without clear civil and commercial laws in the GCC countries, and in the absence ofjust and expeditious channels for legal recourse, the business environment will continue to be fraught with uncertainty and ambiguity, especially regarding the interests of foreign investors. Then there is the matter of the interpretation of interest under Sharia, Islamic law. The judiciary system in these countries has yet to define the rights and obligations of lenders and debtors in a clear and consistent manner, although courts have generally been biased towards debtors. Failure to do so increases the degree of risk and uncertainty in financial markets and can only serve to hinder their development in the long-run.

Capital Markets

Non-bank financial intermediation is an essential component of any successful financial market. In addition to increasing the efficiency of resource allocation, by channeling capital to where it is needed most, capital markets also give privatesector companies greater flexibility in creating a capital structure that befits their type of business and risk tolerance. These markets also increase the flow of information to (and from) potential investors, while at the same time introducing the threat of corporate control, thus minimizing the social costs of agency conflicts between management and shareholders, In order for capital markets to be efficient, however, it is essential that they be supported by a solid and well-organized institutional structure.

In this section, the capital markets of the GCC countries will be analyzed with respect to their inherent characteristics and institutional frameworks.

Debt markets

Debt markets in the GCC countries are very limited in size and scope. The vast majority of securities in these markets are in the form of sovereign bonds and notes. Moreover, bond markets are for the most part highly illiquid. In Saudi Arabia, for example, development bonds and treasury notes are issued by the government to quasi-public agencies and commercial banks, which in turn can only keep them to maturity or sell them back to the state. In addition, and following a request from the Saudi Arabian Monetary Agency (SAMA) in 1978, the market for Saudi Arabian corporate bonds is currently non-existent.23

Although other GCC countries do not impose such severe limitations on the issuance of bonds, the market for these securities remains very thin, with offerings being small and sparse.

The importance of developing efficient fixed-income securities markets in the GCC region cannot be over-stressed. A deep and liquid bond market allows the government to raise capital at a lower cost. Moreover, such a market grants monetary authorities more efficient tools for conducting monetary policy (e.g. open-market operations) while expanding the investment options available to savers. Corporate bonds are also crucial, in that their presence expands the modes available to private-sector companies for raising funds and allows them to achieve a debt-toequity structure that is more commensurate to their needs.

Stock markets

Equity markets in the GCC countries are fairly recent in comparison with the well-established markets of the Western world. The stock market in Kuwait, the oldest in the region, dates back only to the late 1960s, while the other GCC markets were established during the late 1970s. By world standards, the capitalization of the GCC stock markets is small (Figure 11).

In fact the aggregate capitalization of these markets in 1997 ($128.63 billion) was smaller than those of Korea or Mexico. Moreover, the size of these markets varies considerably within the GCC region. The Saudi Arabian stock market, the largest in the Middle East and North Africa region, is at least 22 times larger than that of Qatar and almost seven times larger than those of Bahrain and Oman. Nevertheless, when the economic size of the GCC countries is taken into consideration, their markets seem to be well-capitalized (Figure 12). In fact, the capitalization of the stock markets of Bahrain and Kuwait, relative to GDP, is greater than that of the Chilean, Korean or Mexican markets.

In terms of total turnover, the GCC stock markets do not fare well in comparison to their peers (Figure 13). With the clear exception of Kuwait - which had a turnover ranked fifth worldwide in 1997 and possibly Oman, ranked sixteenth, the total value of traded shares on the GCC stock markets remains very low relative to their market capitalization. This lower market liquidity, which is conducive to higher bid-ask spreads and greater price volatility, is due to several factors.

First, the GCC markets have a very low participation rate. The number of active investors in these countries as a percentage of total adult population is on average less than 3 percent - in comparison to more than 20 percent in developed countries." This lack of interest on the part of domestic investors may be due to the relatively small number of companies that are listed on the GCC exchanges. At the end of 1997, for example, there were only 70 companies listed on Saudi Arabia's stock market in comparison to 257 listed on Turkey's equally capitalized exchange. Another possible reason is the markets' lack of diversification across industrial sectors. Banks are massively over-represented, while shares of service companies and manufacturing firms are few and far between. Also, a large number of the more attractive companies in the region are owned by the state.25 Such a market structure limits the ability of investors to properly diversify their risks and consequently reduces their incentive to invest.

Second, government ownership of listed shares is common in GCC countries. In Saudi Arabia, for example, approximately 25 percent of listed shares are owned by the state .26 Since governments tend to hold on to their shares for longer periods of time, this contributes to lower market liquidity. Third, and in contrast to their Western counterparts, the role of institutional investors in the GCC equity markets remains very small. The absence of such investors has not only reduced the markets' overall liquidity, but it has also restricted their growth prospects. Moreover, the presence of "foreign" institutional investors would have allowed for the flow of direly needed skills and technology into the developing markets of the region.

Equity markets in the GCC region remain highly exclusive and closed to foreign investors. In Bahrain, non-resident foreign investors are allowed access to only five of the 37 companies listed on the exchange. On the Kuwait Stock Exchange (KSE) trading is only open to GCC investors. Oman's stock market is considered to be the most open in the GCC. GCC citizens are allowed to invest directly in its market, while foreign investors can do so through mutual funds. The Doha Securities Market (DSM) in Qatar is only open to its own nationals. On Saudi Arabia's exchange, trading is restricted to GCC nationals, and non-Saudis are only allowed limited direct access. Finally, the UAE, the only GCC country without a formal exchange, forbids participation by foreign investors in the trading of local stocks.27

In an effort to increase the openness of their exchange markets, a number of the more exclusive GCC countries have begun to consider the establishment of mainly closed-end country funds that would be open to non-GCC investors.28 Although the seclusion of GCC exchanges from foreign investors is certainly not conducive to higher growth and liquidity- as demonstrated by the weak performance of Qatar's stock market - the mere act of opening up these markets does not necessarily mean that capital will immediately flow in. A case in point is Oman; despite the Muscat Securities Market's (MSM) openness to nonOmani investors, their presence on the exchange remains negligible.

In order to entice foreign investors, the exchanges of GCC countries need to implement a number of changes. First, they need to increase the number of lucrative investment opportunities available to foreign investors. As mentioned earlier, most of the more promising firms in the region continue to be state-owned. A serious pledge to privatization, accompanied by a well-developed framework for the implementation of such a program, will go a long way in turning the attention of foreign investors to the GCC markets. Second, there is a strong need in the GCC countries to strengthen their regulatory structures and disclosure requirements.

This is not to insinuate that their capital markets are not regulated. In fact, some might argue that these markets are overregulated in some respects. For example, until 1992, Saudi companies that needed to be registered as corporations, let alone be listed on the exchange, required the king's approval. Even today, the Ministry of Finance, among the duties of which is the supervision of financial markets, continues to be restrictive in terms of allowing companies to list on the exchange. A number of other GCC countries have similar restrictions.29 Nevertheless, restricting the number of companies that are traded does not necessarily increase the stabil ity of the market. In order to achieve such a result, regulators need to increase the flow of information to market participants. Disclosure requirements need to be enforced along with the issuance of standardized financial statements and the implementation of proper auditing procedures. Greater transparency of companies will in turn increase the investors' appetite for long-term investments in the region, thereby increasing the depth and liquidity of capital markets. The establishment of an agency such as the Securities and Exchange Commission (SEC) in the United States to supervise capital markets in individual GCC countries (or even at the regional level) can go a long way towards attaining this goal.

By increasing investors' confidence in the region's capital markets, regulators will not only attract funds from non-GCC investors, but will also lure some of the foreign private holdings of GCC nationals. With an estimated value of $400 billion, these holdings constitute a financial powerhouse that most GCC governments have not yet tapped.30 However, as these countries seek economic diversification, and as their ability to rely on petroleum for economic growth diminishes, they will need to encourage the repatriation of private funds held abroad. And this can only be achieved through: (i) offering nationals more lucrative, domestic investment opportunities, (ii) increasing the level of transparency and disclosure in financial markets, and (iii) creating a solid regulatory framework that protects the rights of ordinary investors. Additionally, GCC members should seek greater integration among their capital markets.31 Increased market integration is not only conducive to greater depth and liquidity; it also offers investors a more diversified array of investment options. On the downside however, such diversification will necessarily be limited by the similar structures of the GCC economics and their highly correlated performance over time. Moreover, in order to achieve successful market integration, the regulatory and supervisory frameworks that govern capital markets in individual GCC countries need to be harmonized so as to minimize transaction costs and reduce the implicit barriers to the flow of funds between exchanges.

Up to this point, the discussion has only focused on the economic, financial and regulatory factors that have hindered the development of capital markets in the countries of the GCC. Yet the slow growth of these markets has also been in part due to sociopolitical factors that are even harder to reform. For one, the social perception in the region of a company going public is often a negative one. Selling shares to "outsiders" is many times regarded as a failure of the company oftentimes held by one or a small group of families - and its management to run a profitable operation. Furthermore, the democratization of access to capital that would result from the strengthening of capital markets does not seem to be in harmony with the autocratic political systems of the GCC countries. Free access to capital could lead to the emergence of a new class of wealthy merchants whose views and inclinations might shake the sensitive political balance of these nations.

FINANCIAL-SECTOR DEVELOPMENT AND ECONOMIC GROWTH

The role of financial intermediation in economic development has been vastly debated among economists. Although there exists no general consensus on the direction of causality between financialsector development and economic growth, the importance of the financial sector's role in a nation's growth and prosperity is definite. In his analysis of the issue, Levine argues that the financial sector, the existence of which can be traced back to the presence of transaction and information costs, can affect economic development by positively affecting the rates of capital accumulation and technological innovation in an economy.32 This impact is in turn achieved through mainly five distinct functions that are performed by financial markets and intermediaries, namely: (i) amelioration of risk exposure, (ii) proper allocation of resources, (iii) monitoring and exertion of corporate control, (iv) mobil ization of savings, and (v) facilitation of exchange. In the following sections, these five functions will be discussed in order to properly assess the effect of financialsector development on economic growth in the GCC countries.33

Amelioration of Risk Exposure

In general, investors are exposed to a number of risks when participating in a particular project or acquiring interest in a company. Among these risks is that of liquidity. It is the risk that, when faced with a need to sell, an investor will not be able to divest assets promptly and at a fair price. It is reasonable to believe that fearing such an outcome, many market participants would shy away from longterm projects in favor of ones of shorter duration. This is where the role of financial markets is very valuable. By decreasing liquidity risk, these markets allow for the flow of funds to be channeled into longterm projects that, due to their positive externalities, are of great importance to the process of economic growth and development. In addition to contributing to a general reduction in liquidity risk, financial markets allow investors to diversify away many of the idiosyncratic risks associated with individual projects, thereby encouraging greater involvement in higher-risk, and higher-return projects and improving the allocation of resources across sectors.

Unfortunately, one of the main deficiencies of financial markets in the GCC countries is their lack of liquidity. As discussed earlier, market turnover in most of these countries is low by world standards. As such, these markets have not effectively contributed to a general increase in financial liquidity and thus to the involvement of investors in long-term projects. Furthermore, the ability of investors to diversify their risks has been weakened by the structure of financial markets in these countries, with the manufacturing and services sectors claiming only a small share of overall market capitalization. Therefore, in order to fortify their financial markets' role as a venue for investors to ameliorate their risk exposure, the GCC governments need to (i) increase the participation rate of national investors, (ii) decrease government ownership of listed shares, (iii) reduce the role of specialized credit institutions in longterm lending, (iv) open the door for foreign investors to participate in local markets, (v) strengthen the role of institutional, as opposed to individual, investors, and (vi) strive for greater integration among GCC financial markets. These steps are necessary in order to ensure greater market liquidity and depth.

Proper Allocation of Resources

The role played by financial intermediaries and markets in enhancing the allocation of resources stems from the problem of information asymmetry. Basically, entrepreneurs and managers have greater access to information about their own projects and companies than do potential investors. In order for these investors to acquire such information, they need to incur a cost. Assuming that this cost is fixed, it would be much more efficient for interested investors to share the expense of information acquisition. This is where the role of financial intermediaries comes into play. By acting on behalf of several investors, they are able to minimize the cost and facilitate the dissemination of information to individual investors. In turn, this leads to a more efficient allocation of resources, as owners of capital are able to make more informed judgments on available investment opportunities. Moreover, by channeling funds to the most lucrative entrepreneurial projects and processes, financial markets are also able to accelerate the rate of technological innovation and thus economic growth.

In the GCC countries, the dissemination of information about companies remains an issue to be seriously addressed. As discussed above, there is substantial room for improvement in these countries in the way of sufficient disclosure of financial data on companies, especially those that are not listed on the exchange. If financial markets are to play a constructive role in the allocation of resources in the GCC countries, regulators will have to encourage local companies to issue standardized and audited financial statements on a timely basis. As the more transparent institutions benefit from higher capital flows, this could encourage the more reserved ones to loosen their restrictive policies in order to attract external funds. Yet information disclosure by companies in the region is further impeded by the fact that, in addition to their tightly knit ownership structures, a number of the more profitable private institutions benefit from considerable rents that are difficult to justify, or price, on a purely financial basis. Furthermore, the disclosure of these rents could expose these companies to public scrutiny and have serious political ramifications that further dampen their desire for greater transparency.

Monitoring and the Exertion of Corporate Control

One of the oldest dilemmas in the world of business is that of "agency" cost. It is a problem that is caused by the difficulty of aligning the objectives of a company's owners with those of its managers. In the presence of agency problems, investors might be dissuaded from lucrative projects, and resources might not be allocated in the most efficient manner. By introducing the threat of corporate control, financial markets force managers to prioritize the maximization of share value, thereby merging their interests with those of stockholders. Such an outcome could also be achieved by linking the compensation of managers to the performance of their company's stock. In addition to capital markets, the presence of financial intermediaries allows for more effective monitoring of companies and projects once loans have been extended. This is possible because banks act as "delegated monitors" on behalf of a group of lenders and thus are able to sustain the costs of closely observing the debtor's financial operations. In the absence of such intermediaries, the cost of monitoring might be prohibitive for individual lenders. This in turn could impede economic development by restricting the flow of funds to projects of substantial economic and social benefits.

Financial markets in the GCC countries have still not developed to the point where the threat of corporate control is a significant factor in determining firm behavior. Most of the private sector companies in the region have very tight ownership structures, and in most cases the line separating management from stockholders remains very thin. Furthermore, the monitoring role of financial intermediaries has been dampened by the lack of transparency of companies and their reluctance to issue financial statements in a timely and consistent manner. Here again, the interests of prospective and current investors seem to have been overlooked in favor of preserving the privileges of those benefiting from the existing market structure. However, such a structure is neither conducive to the proper development of financial markets nor does it lead to the channeling of capital to where it is needed most. In order to promote a more efficient allocation of resources and to attract the vast funds held by the GCC nationals abroad, it is important that disclosure standards be raised and the role of financial intermediaries as "delegated monitors" strengthened.

Mobilization of Savings

Among the most important roles played by financial institutions and markets is that of mobilization, or pooling, of savings and capital. For in the presence of transaction costs and information asymmetries, it becomes quite difficult for owners of capital to seek lucrative investment opportunities on their own and furthermore to trust that their funds will be handled in a manner that meets their interests. The absence of small-denomination instruments could similarly deter smaller investors from participating in large-scale ventures, thereby diminishing their feasibility and compromising the potential private and social benefits that could have resulted from their implementation. At the opposite end of the market, entrepreneurs and companies are in need of external capital in order to develop their ideas and grow. This need is accentuated by the importance of economies of scale in today's production processes and by the high costs of new technology. Therefore, the central role that financial intermediaries play in pooling savings and capital is elemental to economic growth and prosperity. As stated by Levine:

By enhancing risk diversification, liquidity, and the size of feasible firms, therefore, mobilization improves resource allocation .... [Furthermore], by effectively mobilizing resources for projects, the financial system may play a crucial role in permitting the adoption of better technologies and thereby encouraging growth."

In the GCC countries, a large part of private savings has been channeled abroad. Even financial intermediaries have turned to foreign markets for investment opportunities, as indicated by their large holdings of net foreign assets. The effect of this on economic growth in the region cannot be positive. With savings not being recycled into the economy, domestic investments will surely suffer, which in turn would limit the prospects of young entrepreneurs and dampen the growth of the non-oil sector. However, placing the blame on banks and financial markets for such resource misallocation would be unmerited. In fact, when financial markets have been given a chance to mobilize savings for domestic projects, they have generally performed with considerable success. Most share issues in the region tend to be oversold, sometimes as much as 12 times.35 It could therefore be argued that the reason behind the flight of savings abroad is not the inefficiency of financial intermediaries but the dearth of lucrative domestic opportunities available to investors. In order to entice the repatriation of capital and savings from abroad, the GCC countries need to accelerate their privatization programs while enforcing stricter disclosure standards and establishing an expeditious and equitable legal system.

Facilitation of Exchange

One of the main elements contributing to higher productivity and economic growth is the specialization of factors of production. Specialization allows for reduced production costs and for the unleashing of technological creativity and innovation. However, with the process of specialization comes an increase in the level of interaction and exchange between business entities, which in turn brings to the forefront the issue of transaction costs. By facilitating exchange between business entities, financial markets and intermediaries reduce these costs, thereby facilitating the process of specialization and contributing to the process of development and growth.

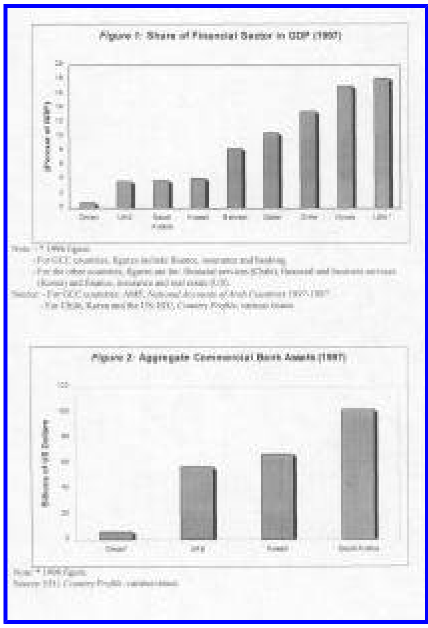
The lack of economic diversification in the GCC countries has weakened the role of financial intermediaries as facilitators of exchange between economic entities. The process of specialization, which necessitates the creation of special financial arrangements between market participants, is still in its infant stage in most of the GCC countries. And the dominant role that petroleum continues to play in their economies has effectively stemmed the development of an active non-oil private sector. Therefore, and in the absence of a sincere government resolve for economic diversification, the role of banks as facilitators of exchange has been mostly confined to trade-related financing. Although such a service is essential to the free flow of goods and services across borders, it does not capitalize on the ability of financial intermediaries to facilitate transactions and foster economic growth in the GCC countries.

CONCLUSION

With the increasing sophistication of today's clients and the diminishing importance of geographic location to the provision of financial services, maintaining a competitive advantage in global financial markets has become an increasingly challenging task. The challenge is even greater for the nascent financial markets of developing countries that are attempting to establish a global presence in an industry where economies of scale and scope have become essential to success. To this end, the GCC financial markets still have a long way to go before attaining a prominent role among global players. Their path to success, whether at the international or regional levels, should start with the implementation of the necessary reforms. In the banking sector, there is a need for (i) greater consolidation among banks in order to take advantage of the increasingly important economies of scale, (ii) lower barriers to competition, especially from foreign institutions, (iii) explicit elimination of any restrictions on depository and lending rates, (iv) improvement in marketbased mechanisms of bank control, and (v) implementation of consolidated banking supervision standards. Capital markets, on the other hand, would greatly benefit from the development of deep and liquid debt markets, the easing of restrictions on the listing of companies, the expansion of the role of institutional investors and the opening of markets to foreign investors.

In general, the advancement of the region's financial markets is highly dependent upon an increase in the transparency of companies and the introduction of more stringent disclosure requirements. Furthermore, the GCC governments need to make a sincere commitment to the process of privatization. A well-designed privatization program has numerous advantages for these countries, among which are (i) the enhancement of the asset mix of banking institutions, (ii) the development of deeper and more liquid capital markets, (iii) the creation of greater investment and diversification opportunities for domestic investors, and (iv) the luring of foreign capital and technology. Additionally, it is imperative that a fair and expeditious system for legal recourse be instituted. The presence of such a system is essential to the enhancement of investors' confidence in the region and to the reduction of inefficiencies and transactions costs.

Without the implementation of such reforms, the role of financial markets in the GCC will continue to be confined within domestic boundaries, with little hope for any prominent global presence in the near future. Moreover, these changes are necessary if financial intermediaries are to play a constructive role in the efficient allocation of resources and the mobilization of capital. The postponement of such reforms will only serve to dampen the effectiveness of financial markets in advancing economic development and growth in the GCC countries.



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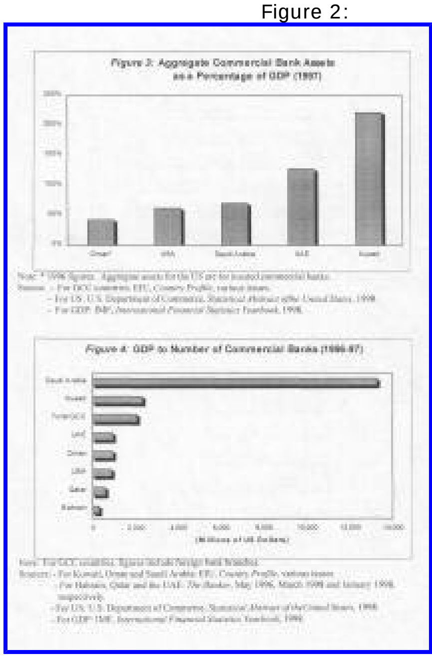

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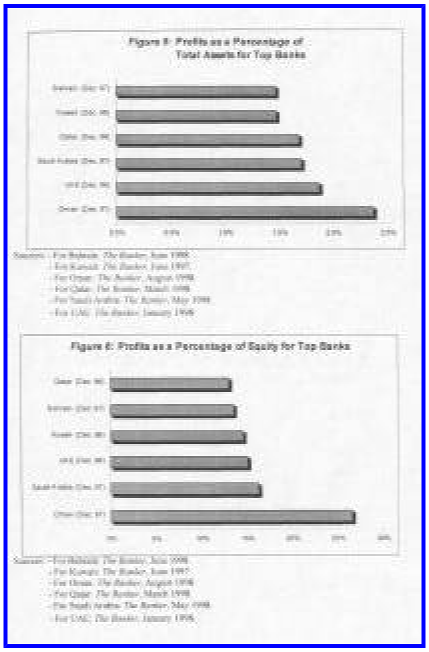

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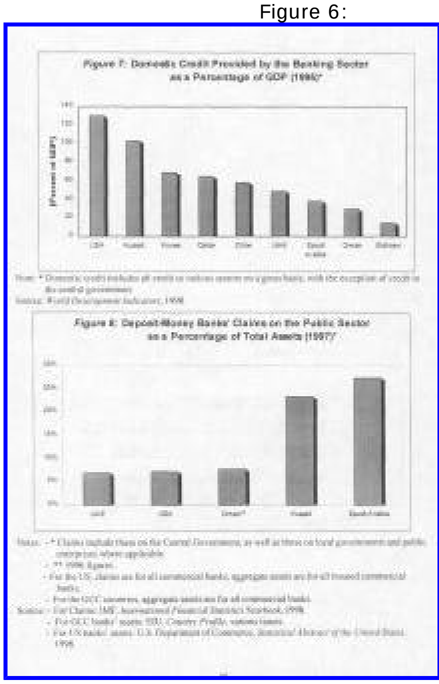

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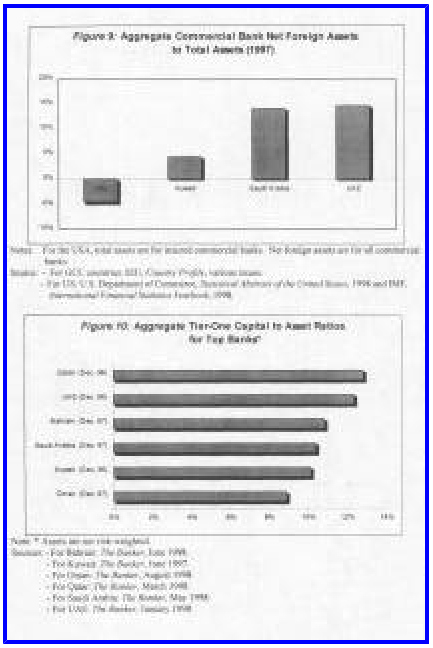

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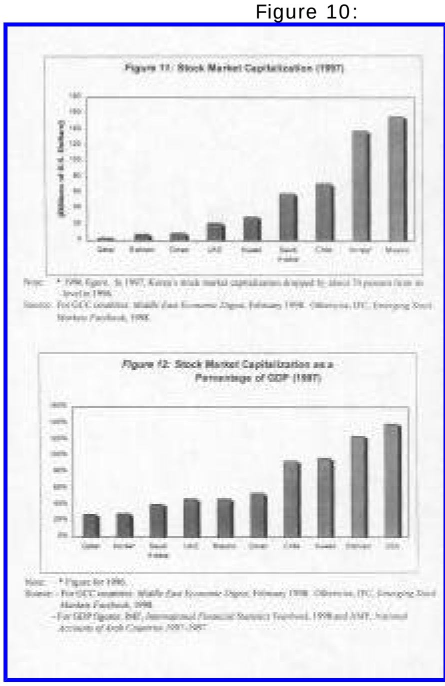

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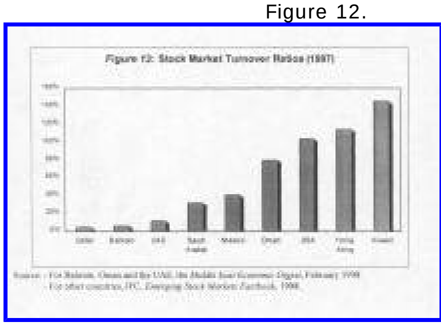

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Figure 13:

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1 Abdelali Jbili, Vincent Galbis and Amer Bisat, "Financial Systems and Reform in the Gulf Cooperation Council Countries," Financial

Systems and Labor Markets in the Gulf Cooperation Council Countries, International Monetary Fund, November 1997.
2 Valuation figures for bank assets in the region should be viewed with caution. Among the issues to be considered is the value of real estate that is carried on the balance sheets of commercial banks. In many instances these numbers tend to be inflated and do not reflect the true value of the underlying assets. "A Question of Assets," Middle East, July 1998.
3 Salem Abdul Aziz Al-Sabah, "Gulf Banking in the Nineties: Challenges and Strategies," Middle East Policy, Vol. 3, No. 4, April 1995, p. 97.
4 Jbili et al., p. 4.
5 Although barriers to the entrance of foreign-banks are in force in all GCC countries,_many banks in the region

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have begun to espouse outward looking strategies. In their quest for a more global role in financial markets, many of the region's more powerful financial institutions- such as the Arab Banking Corporation, the Gulf International Bank and the National Bank of Kuwait - have been pursuing an outward-looking strategy through foreign branching and strategic alliances with foreign institutions. Josh Martin, "A Brave New World for Arab Banks," Middle East, July 1998.
6 John Duke Anthony, "Special Report: Consultation and Consensus in Kuwait: The 18' GCC Summit," Middle East Policy, June 1998.
7 Please refer to Mark Selway, "Gulf Takes a Fall," The Banker, September 1998. 8 Al-Sabah, p. 97.
9 Jbili et al., p. 7.
10 It is important to note that the capital-to-asset ratios used here are not risk-based. However one could safely assume that the risk-based capital-to-asset ratios would be even higher than the simple ratios used here due to the following factors: (i) these ratios do not take into consideration the banks' tier-two capital, (ii) the value of assets in the denominator is not risk-weighted, and (iii) the volume of off-balance-sheet activities of GCC banks is relatively small.
11 Khaled M. Al-Fayez, "International Developments and their Impact on Gulf Banks," Middle East Policy,

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Vol. 3, No. 4, April 1995, p. 106.
12 For further elaboration on this topic, please refer to Joseph E. Stiglitz, Jaime Jaramillo-Vallejo and Yung Chal Park, "The Role of the State in Financial Markets," World Bank Research Observer, Annual conference on development economics supplement, 1993.
13 For further elaboration on this issue, please refer to Ibrahim F. 1. Shihata, "Some Recent Trends in Banking Law and their Relevance to the GCC States," The World Bank, November 1996.
14 It is important to note that a number of these new developments have found their way into the regulatory framework of the GCC countries through detailed regulations and instructions issued by the banking industry's supervisory bodies. Moreover, due to the fact that banks in the GCC countries are generally

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required to register as joint-stock companies, they have also been affected by a number of changes to commercial laws and codes that have sometimes included clauses that specifically targeted the operations of the banking industry. Ibid.
15 Ibid., p. 26.
16 A related issue to that of financial institution transparency is that of customer "confidentiality": the "nondisclosure of customers' banking, financial or economic information either by banks themselves, through their systems or staff, or by those who receive such information by virtue of their profession" (Al-Sabah, p. 98). Although its advocates have consistently maintained that customer confidentiality is necessary for the creation of a stable banking environment in the region, the growing international campaign against money laundering has been firmly pitted against it. As the international operations of GCC banks grow over time, this thorny issue is bound to gather more attention and will surely require an extensive review by the GCC's banking supervisory agencies.
17 Shihata.
18 Although banking laws in the GCC countries are restrictive in terms of banks pursuing non-traditional

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banking activities, some of these restrictions have been partially relaxed through the introduction of new rules and regulations by supervisory agencies. Among the GCC countries, UAE laws could be classified as being the most restrictive in terms of curtailing any form of universal banking. At the other end, the banking laws in Oman are unique among GCC nations in that they "explicitly" authorize banks to deal with a large variety of securities (Ibid.).
19 Ibid.
20 Ibid.
21 Ibid.
22 For further elaboration on this issue, please refer to Jbili et al., p. 13 and Luca Errico, "Islamic Banking:

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Issues in Prudential Regulations and Supervision," International Monetary Fund, Working Paper No. 98/30, 1998.
23 Jean-Francois Seznec, "The Gulf Capital Markets at a Crossroads," The Columbia Journal of World Business, Fall 1995.
24 Henry Azzam, "Preparing for a Global Future," The Banker, November 1997. 25 Edmund O'Sullivan, "Stock Markets Special Report," MEED, February 13, 1998. 26 Ibid.
27Ibid.
28 In June 1997, the Saudi Arabia Investment Fund (SAIF) - a closed-end country fund - was launched on the London Stock Exchange. It successfully raised $250 million from international and domestic investors. Ali J. Baruni, "The Saudi Arabian Stock Market," Arab Bankers Association ofNorth America, Vol. 15, No. 3, September 1998.
29 It should be noted that the over-protectionist role of regulators in the GCC countries has been fueled to a

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large extent by the 1982 stock market crash in Kuwait. As a parallel market, Souk-Al-Manakh as it was called, was hit by a huge speculative bubble that burst leaving investors bankrupt and banks debt-ridden. The market collapse left more than $90 billion of post-dated checks outstanding. To this day, negotiations on the proper compensations and write-offs are still ongoing between creditors, debtors and the Kuwaiti government which in fact rescued local banks by exchanging their outstanding debt for government bonds (Seznec).
30 Anthony.
31 In May 1997, Kuwait and Bahrain entered into a cross-trading agreement allowing citizens of either country to trade in shares listed on either stock exchange through their local brokers (O'Sullivan).
32 Ross Levine, "Financial Development and Economic Growth: Views and Agenda," Journal ofEconomic Literature, Vol. 35, June 1997.
33 The theoretical analysis in the following sections relies extensively on Levine's analysis of the issue (Nd.).
34 Ibid., p. 699-700.
35 Seznec.
